

Gergely Kiss: Experiences of European crisis management: the reform of economic policy coordination*

This article is intended to present the new, (re)forming elements of economic policy coordination, an instrument playing a central role in the EU. One important lesson drawn from the crisis is that in order for the EU to become a stable, dynamically growing economy – in addition to its internal market (in particular, the free movement of capital) and a single monetary policy – there is a need for efficient coordination, which should also be credible for the markets. Economic policy coordination – the alignment of national fiscal policies to one another and, for euro area Member States, to the common monetary policy – is a key issue, and the intention to reform it is closely related to the crisis management of the past two years.

The proposals presented thus far indicate that EU policy makers are firmly committed to setting up economic policy coordination mechanisms which are far more efficient than those already in place. Accordingly, they will rigorously assess both fiscal and real economic imbalances, and after the imbalances have been identified, they will readily enforce corrective mechanisms, including sanctions more severe than those already in place. Rules governing crisis management will certainly be clearer; however, in order to minimise moral hazard, the common European rescue package will continue to have a hefty price tag.

It is a warning sign, however, that despite firm policy intentions, markets remain rather sceptical about the reform of the fiscal framework and the ability to guarantee the sustainability of fiscal policies, as indicated by the sovereign credit risk premia, which by September had risen to the levels observed in May.

INTRODUCTION

This article presents the new, (re)forming elements of economic policy coordination, an instrument playing a central role in the European Union (EU). One important lesson drawn from the crisis is that in order for the EU to become a stable, dynamically growing economy – in addition to its internal market (in particular, the free movement of capital) and a single monetary policy – there is a need for efficient coordination, which should be credible for the markets as well. Economic policy coordination – the alignment of national fiscal policies to one another and, for euro area Member States, to the common monetary policy – is a key issue, and the intention to reform it is closely related to the crisis management of the past two years. In our analysis, the proposals are presented within a broader economic context with a retrospective view of the extraordinary policy measures taken as a response to the global financial crisis. The primary purpose of this article is to provide information about the still ongoing thinking process that is taking place in European institutions and major Member States.

The structure of this article is as follows: first, we provide a brief overview of the extraordinary policy measures taken since autumn 2008 and, subsequently, we proceed to address the second wave of the crisis in the EU and describe the proposed new elements of the coordination directly in relation to the intensification of sovereign risks.

REASONS FOR THE FISCAL AND MONETARY EASING

In the autumn of 2008 the repercussions of the global financial crisis were spreading rapidly to the real economy. Striving to reinforce the stability of the global financial system, governments and central banks around the globe implemented extraordinary measures and adopted fiscal and monetary easing to counter the deepening recession. It was clear from the start of crisis management that recovery from the global crisis hinged upon the concerted action of major economies and, in recognition of this necessity, the negotiations of the G20, which comprises the world's largest economies, assumed an increasingly important role and introduced the most important crisis management measures.

* The views expressed in this article are those of the author(s) and do not necessarily reflect the official view of the Magyar Nemzeti Bank.

Decision-makers were also aware that the extraordinary measures they adopted could only be effective if the fiscal easing did not prompt markets to call into question the sustainability and the long-term equilibrium of the economies.

The fiscal easing, which was rather pronounced across the European Union, took place within the framework of the EERP (European Economy Recovery Plan). It is difficult to present exact figures, but by 2009 the consolidated ESA-based EU budget deficit – which also includes the deficit increasing effects of the automatic stabilisers in times of recession – increased to 6.9 percent from the 2.8 percent observed in the previous year, while the increase in the debt ratio between 2007 and 2010 amounted to around 20 percentage points.¹ According to the ECB's estimates (ECB 2010a), the fiscal packages provided under the EERP in the euro area amounted to 2 percent of GDP over a two-year period (2009–2010).

It should be noted at this point that this significant fiscal easing alone gave rise to considerable tensions as regards compliance with the provisions of the Stability and Growth Pact (SGP). Of the 27 Member States 25 countries are currently subject to the so-called excessive deficit procedure (EDP). This means that, with deficit ratios in excess of 3 percent of GDP, none of the EU Member States meets the budget deficit criterion except Sweden and Estonia.

Following the acute phase of crisis management, decision-makers shifted their focus to exit strategies, i.e. the reversal of extraordinary measures. The announcement of the exit strategy did not mean in itself that its implementation started immediately; it was merely intended to demonstrate to the markets the manner in which economic policy would return to normal functioning. A good illustration of a timely announcement of the exit strategy is the European Central Bank (ECB): as early as September 2009, in a much anticipated speech President Trichet provided a detailed overview of the ECB's exit strategy, stressing the ECB's commitment to price stability and the temporary nature of the crisis management measures. Nevertheless, the gradual re-absorption of monetary liquidity began only at a later phase, and the ECB's key interest rate stands at a record low, 1 percent, even as of September 2010.

Fiscal consolidation is perhaps an even more pressing issue. We might state in general, that fiscal easing is only an option if it does not call into question the sustainability of

public finances. Even if such is the case, it will not have a noticeable stimulating effect if the private sector immediately starts offsetting it by increasing its savings in anticipation of a future fiscal tightening (Ricardian equivalence).² At the time the crisis management plan was adopted most signs indicated that the fiscal policy had accumulated sufficient credibility for the fiscal stimulus to generate a short-term effect. However, it was clear that the fiscal policies of individual Member States had to start addressing the issue of consolidation as well, and finding an answer, as soon as possible, to two questions: at what levels individual Member States intended to stabilise their debt ratios, and where they would find the funds for the consolidation that was required to achieve that target.

INTENSIFICATION OF SOVEREIGN RISKS, THE SECOND WAVE OF THE CRISIS

The first results of the fiscal stimulus were very positive: the EU economy demonstrated a quarter-on-quarter growth from as early as the middle of 2009 and, amid gradually restored confidence in the capital markets, credit spreads began to decline markedly. For the EU, however, new tensions started to simmer under the surface. While the G20 negotiations were sufficient at the global level, as regards the EU – in particular, the euro area – the attempt to align fiscal policies to the regulatory framework imposed by the Stability and Growth Pact (SGP) failed to produce convincing results. Indeed, following the overheated period of the preceding years, the depth of the recession faced by certain Member States was so astounding that – given the lack of firm fiscal measures – it raised increasing concerns about the sustainability of public debt.

While the sustainability of the debt trajectory is crucial for each country; in the case of the euro area two additional aspects should be considered in its assessment. On the one hand, even though the deep economic recession might warrant further monetary easing in a specific country, under the single monetary policy it is impossible to adjust monetary conditions to address the problems of a single Member State. On the other hand, as the single currency implies joint fiscal responsibility, leaders of the euro area concluded that none of the Member States should be allowed to go bankrupt; nonetheless, the moral hazard arising from the European aid also need(ed) to be addressed. Indeed, the SNA clearly declares that neither the European institutions nor the ECB can rescue individual Member States (no bail out).

¹ In addition to high deficit levels, the stimulus packages provided by the government to the financial sector during the crisis largely contributed to the increase in the debt ratio.

² In fact, the arising of the Ricardian equivalence is somewhat more complicated than that: with sufficiently heterogeneous economic participants, fiscal stimulus could easily have a material short-term effect.

A frequent form of “assistance” applied at the national level in previous decades was the direct provision of central bank financing to the government, in other words, turning on the money presses. Obviously, this did not solve any problems over the long run and merely induced inflation, but over the short run it was a convenient solution for governments. Contemporary central bank acts provide for the prohibition of monetary financing precisely to prevent this kind of practice at the institutional level. In the case of the EU, this specifically means that the ECB and the other central banks are not allowed to extend loans to public institutions, and cannot purchase the government securities of individual Member States directly in the primary market.³

In early 2010 – during the intensification of the Greek crisis – decision-makers of the Union were tied up for months with debates over the moral hazard associated with European assistance and rescue.

It was not until May 2010 that a clear and resolute response was agreed upon, when several crisis management measures had to be adopted at an extraordinary weekend meeting prompted by the renewed escalation of market tensions. As a result, the Council of Economic and Finance Ministers (Ecofin), in cooperation with the IMF, decided to set up a massive (EUR 440 billion) common euro area fund (European Financial Stability Facility, EFSF),⁴ which can be used by distressed euro area Member States if financing themselves from the market is no longer possible. Loans granted by the fund are guaranteed by euro area Member States. In each case, when a Member State indicates that it seeks this assistance, the Member States jointly extending the loan must make a separate decision in line with their own national regulations.

Simultaneously, the ECB also passed a number of important decisions: it announced that, with a view to restoring the normal functioning of the monetary transmission mechanism, it would begin to purchase government securities in the secondary market (Securities Market Programme, SMP). It also introduced additional liquidity providing instruments. In addition, Member States expressed a firm commitment to pursuing a sound fiscal policy and, to this end, decided to reform the fundamentals of economic policy coordination.

Before providing an economic assessment of the individual items in the proposals, it is worth looking at the prevailing rules and their practical weaknesses.

THE EXISTING SYSTEM OF ECONOMIC POLICY COORDINATION

As the official title of the euro area, the Economic and Monetary Union (EMU), aptly indicates the – currently – 16 Member States⁵ not only constitute a monetary union, but they are also expected to coordinate their national economic policies, in general, and their fiscal policies, in particular. From the perspective of economics the explanation is rather simple: a common monetary policy can only accomplish its primary mission – price stability – if it is supported by a sound fiscal policy. In practice, the rules are set out by the Stability and Growth Pact (SGP).⁶ The regulation has two particularly vulnerable aspects. On the one hand, it must be ensured that each Member State pursues a sound fiscal policy and that new Member States are not allowed to become a “free rider” to benefit from the stability of the euro area as a whole. On the other hand, the rules should define unambiguously what “sound fiscal policy” means and how to impose it on Member States. The SGP does not apply to euro area members only; the rules it sets forth must be observed by all EU Member States. However, there is an important difference: the assessment of the fiscal convergence criteria during the accession process focuses on two specific figures: public debt cannot exceed 60 percent of GDP,⁷ and the general government deficit must be below 3 percent of GDP. There is another difference, which is relevant to Hungary as well: in the case of EU Member States outside of the euro area, a breach of fiscal rules has not resulted in any material sanctions thus far. Although the applicable rules of the excessive deficit procedure (EDP) empower the EU to suspend payments from the Cohesion Fund to any Member State if the Member State concerned persistently fails to act upon the recommendations aimed at reducing the deficit, this has never been applied in practice.

At the time the rules were formulated, no-one expected that a severe crisis such as that observed in the first half of 2010 would unfold barely 10 years after the euro had been adopted. At the beginning of the year, “only” a few Member States were

³ Moreover, the ECB will not conduct interventions even in the secondary market of government securities unless these are necessitated by disturbances in the monetary transmission mechanism.

⁴ In addition to the EFSF, they also established a so-called European Financial Stability Mechanism (EFSM), which can grant a loan or credit facility guaranteed by the EU up to EUR 60 billion, available to any EU Member State. (In addition to the two funds mentioned above, the so-called Balance of Payments assistance remains available to Member States not participating in the euro, the ceiling of which is currently EUR 50 billion).

⁵ With the accession of Estonia, the euro area will consist of 17 Member States by 2011.

⁶ Bences and Kutasi (2010) provide a current and detailed overview of the relevant rules.

⁷ In case of a public debt level higher than 60 percent, a sufficiently diminishing debt ratio will suffice. This is the reason why Belgium and Italy were able to meet the fiscal criteria upon the adoption of the euro despite a debt ratio exceeding 100 percent of GDP.

subject to scrutiny in relation to their fiscal sustainability, as evidenced by the evolution of the CDS spreads, the measure of sovereign risk. Undoubtedly, during this period Greece was at the epicentre of the crisis. Greek risk premia soared to nearly 1000 basis points – a level never before seen in the EU. Market participants were no longer convinced that Greece could recover from the crisis on its own, and yet negotiations on a plan for international assistance progressed very slowly. As discussed above, owing to concerns about the moral hazard associated with potential EU assistance and the no bailout clause of the SGP, the decision-makers of the Union waited very long to reach a decision on the aid to be offered to Greece jointly with the IMF.

The Greek situation, however, had become a pan-European issue not only on account of its precedential value, but also because of the increasing threat of contagion of the crisis. By May market participants had begun to lose confidence in the entire euro area. They had no way of knowing what resources and mechanisms were available to the euro area as a whole to support distressed Member States. Markets were extremely worried about a possible domino-effect induced by the potential defaulting of vulnerable countries, as it would have imposed too great a burden on the entire euro area for even the more stable countries to finance. On the one hand, these fears were reflected by the substantial weakening of the euro, on the other hand, they contributed to the disturbances in the government securities market and to the rising risk premia even for ostensibly more stable Member States.

In autumn 2010, all these facts clearly indicate that the European institutional system was unable to ensure fiscal discipline either in the euro area or in the broader EU, and that the European mechanism was not functioning smoothly during the process of crisis management. The crisis made decision-makers realise that the rules needed to be revised significantly, and that the future of the euro could not be secured without a serious reform. The specific proposals are presented below.

PROPOSALS AIMED AT THE REFORM OF ECONOMIC POLICY COORDINATION

As regards proposals for the future, we should look back to March 2010. In the spring, during the intensification of the Greek crisis it was already clear that the longer-term problems of the European economy had to be addressed at the EU level. Accordingly, the European Council (EC), which comprises heads of state and government, announced its new strategy – known as Europe 2020 – for the creation of jobs and the promotion of growth. The main elements of the strategy are aimed at increasing employment, improving

the conditions for education and R&D, increasing energy efficiency, reducing the emission of greenhouse gases and combating poverty. In addition, the Council decided to set up a Task Force (TF) headed by the President of the EC, Herman Van Rompuy, in which the finance ministers of the Member States and representatives of the ECB and the European Commission work together to develop an efficient crisis management framework and a series of measures required for greater fiscal discipline. The TF will present its final report and proposals during the October 2010 meeting of the European Council. Before looking at the details, we should note that, in parallel to – but institutionally independent of – the work undertaken by the TF, other, equally relevant reforms are being developed with a view to reinforcing financial stability (e.g. laying down the Basel III Directive, setting up the European Systemic Risk Board).

PROPOSALS OF THE VAN ROMPUY TASK FORCE (TF)

The first meeting of the Van Rompuy Task Force was held shortly after the turbulence in early May. At the start of the work process, participants agreed on four major objectives:

1. Enforce greater fiscal discipline; strengthen the rules of the SGP
2. Establish macroeconomic surveillance, similar to fiscal surveillance, as part of the process, reduce divergences in competitiveness between the Member States
3. Set up an efficient crisis management mechanism
4. Strengthen broader economic governance in institutional terms

At its second meeting, the TF provided further details on the first two issues, budget surveillance and macroeconomic surveillance. Within this framework, they intended to revise several points of the Stability and Growth Pact to ensure that Member States in breach of the fiscal rules may be sanctioned at an earlier stage and in a more gradual way. Specific proposals relevant to this issue are as follows:

- Adoption of the so-called “European Semester” as of 2011. Practically covering the first half of each calendar year, Member States would coordinate with the European Commission in respect of the main assumptions underlying their budgetary plans for the following year. Since this coordination would be concluded prior to the budgetary debates of each Member State, national parliaments would be able to make a decision in consideration of its results.

- Extend the early sanctions of the SGP, for example in cases where the level of debt rises too quickly even before the 3 percent deficit threshold is breached. Figuratively speaking, similar to traffic lights, you would now get a ticket not only for running a red light, but also for running a yellow light. At the same time, the TF stressed that the specific rules and sanctions would have to be defined precisely.
- The level and sustainability of public debt should play a bigger role in budget surveillance, especially for countries with a sharply rising debt ratio.
- There is a need to guarantee the independence of national statistical offices (by keeping data provision free from political pressures) and to ensure that Member States report sufficient and reliable statistical data.

As regards macroeconomic surveillance, one important conclusion drawn by the TF from the experiences of the crisis was that sound budgetary policies were necessary, but not sufficient to ensure the competitiveness of the economy. This may give rise to problems particularly for members of the euro area, where devaluation with a view to improving competitiveness is no longer an option. Accordingly, the TF proposed the application of indicators to monitor competitiveness and imbalances (scoreboard), and asked the European Commission to work out the specific details in that regard.

Based on the initial sub-report of the TF, the EC approved the main approaches and set a deadline – October 2010 – for the submission of the final report.

PROPOSALS OF THE EUROPEAN COMMISSION

By the end of June 2010, the European Commission had prepared its proposal presenting in detail the specific steps⁸ outlined below.

In relation to macroeconomic surveillance, the European Commission proposed a two-stage approach.

In the first stage (prevention), the Commission would assess the external and internal imbalances of each Member State on the basis of an overall indicator system (scoreboard). Based on the emphatically non-mechanical assessment, the Council may issue country-specific proposals, which may include policy recommendations addressing a broad range of issues covering macroeconomic policies, labour markets as well as goods markets or macro-prudential matters. In

particularly serious cases, the Commission may recommend placing a Member State in an excessive imbalances position (similarly to the excessive deficit procedure).

The purpose of the second stage (correction) is to enforce compliance with the recommendations issued in relation to the specific case. The excessive imbalances position mechanism would apply to all EU Member States (in practice, it is expected to function in a manner similar to the excessive deficit procedure; in other words, the Council would issue recommendations to the affected Member State, the implementation of which would be regularly monitored). However, non-compliance with the recommendations would result in more stringent sanctions for euro area Member States, as in their case imbalances might jeopardise the entire euro area.

In the area of fiscal surveillance, first and foremost, the Commission emphasises the importance of high quality, independent statistics, and proposes that Member States develop national fiscal rules and multi-annual budgetary planning. The Commission dedicates a separate chapter to the significance of sustainable debt. In this context, as a preventive measure, the Commission would introduce stricter criteria for highly indebted countries in respect of the deficit. In this framework, Member States with debt ratios in excess of 60 percent of GDP could become subject to the excessive deficit procedure if the decline in debt falls short of the satisfactory pace of debt reduction. As regards corrective measures and the abrogation of the excessive deficit procedure, the Commission recommends the adoption of a simple and clear rule: with a debt ratio exceeding 60 percent of GDP, bringing the deficit below 3 percent of GDP would not be sufficient for lifting the excessive deficit procedure if the additional criterion of a declining debt ratio is not satisfied at the same time.

The Commission intends to take account of several additional parameters in the assessment of a sustainable debt level, such as the maturity structure and currency denomination of public debt, state guarantees, and implicit liabilities (e.g. future costs related to the ageing of society).

The Commission addresses the issue of future sanctions in great detail. It states, in general, that the breaching of rules could not be prevented in the past, and so sanctions need to be much more rule-based and applied on a case-by-case basis; in other words, a wider range of sanctions should be introduced. Another principle is to ensure that sanctions kick in at a much earlier stage, and it is necessary in their application to seek effectiveness and equal treatment

⁸ Before this document was prepared, the Commission had drawn up a similar material in early May; however, it was not ordered by the Van Rompuy Task Force.

between Member States. To ensure proportionality, financial sanctions would be defined as a percentage of the GDP of the relevant Member State (up to an identical upper limit for all Member States).

In the preventive stage – when a Member State is not making sufficient progress towards its medium-term budgetary objective – they would impose an interest-bearing deposit on euro area Member States and, applicable to all Member States, cohesion support would be disbursed pending on the implementation of structural and institutional reforms.

As regards the corrective stage – when the specific country is subject to an excessive deficit procedure – the Commission proposes a new system of financial sanctions. In essence, this would deploy the EU budget to enforce compliance with the rules set forth in the SGP. Sanctions should not affect items directly transferred to individual beneficiaries, but rather payment to Member States. On this basis, cohesion support or payments under the Common Agricultural Policy could be suspended or cancelled altogether.

Finally, the document provides technical details relating to the “European Semester” in light of its forthcoming adoption in 2011.

ADDITIONAL PROPOSALS

Several governments and institutions have commented on and added further proposals to the work undertaken by the TF. Since the opinions offered by different countries are generally not public and they are discussed within the Task Force (at the sherpa level), and since the work of the TF has not yet been concluded, we present below only two, high-

profile proposals: that of the ECB and the joint position of the French and the German government.

The Governing Council of the ECB released its own position on 10 June 2010 (ECB, 2010b). It set out proposals – in particular for the euro area – in three areas: strengthening surveillance over budgetary positions; an improved framework for competitiveness surveillance with a more efficient management of imbalances; and finally, establishment of a viable crisis management mechanism. According to the ECB, a quantum leap forward is needed in order to sufficiently reinforce the institutional foundations of the euro area. Among the details, two new items should be highlighted: in an attempt to tighten fiscal rules, the ECB would establish an independent, EU-level fiscal agency and propose that the suspension of voting rights be included in the spectrum of sanctions.

The joint German-French statement was issued on 21 July 2010, following the third meeting of the TF. As an introduction, they confirm their commitment to making the institutional framework of the economic policy more efficient, and they also agree on the three most important areas: revision of the preventive and corrective rules and setting up a crisis management mechanism. It is an important element of the joint position that they propose extremely stringent sanctions for Member States breaching the rules of the SGP: in addition to the suspension of payments from the Cohesion Fund – pending an appropriate legal basis – they also propose, similarly to the ECB, a suspension of voting rights for Member States that repeatedly fail to comply with the rules.

There is consensus about the need to have in place a crisis management framework that guarantees to minimise moral hazard. This can be achieved by ensuring from the outset

Table 1

Chronological order of the specific proposals

Date	Institution	Main proposals and novelties
26 March 2010	European Council (EC)	EU 2020 programme, setting up the Van Rompuy Task Force
10 May 2010	Ecofin	A common European rescue package and a firm commitment to sound fiscal policy
21 May 2010	Van Rompuy Task Force	Identifies the 4 main areas to be reformed: fiscal discipline; competitiveness surveillance; crisis management mechanism; more efficient coordination
7 June 2010	Van Rompuy Task Force	Presents detailed proposals relating to budgetary and macroeconomic balance
10 June 2010	ECB	Urges very resolute measures; independent fiscal agency, tough sanctions
17 June 2010	European Council (EC)	Supports the approaches of the TF theretofore; commitment to improved coordination
30 June 2010	European Commission	Presents specific proposals about several issues (e.g. European Semester, sanctions, macroeconomic imbalances)
12 July 2010	Van Rompuy Task Force	Focuses on the sustainability of debt; works out the stages of macroeconomic surveillance
21 July 2010	Joint proposal issued by the French-German governments	Strict sanctions against Member States in breach of the rules
6 September 2010	Van Rompuy Task Force	Presents budget surveillance and macroeconomic surveillance; a detailed overview of sanctions

that receiving assistance from the Union is tied to the fulfilment of stringent conditions. Nevertheless, it should be noted that, despite months of work, the markets do not have confidence in an efficient future crisis management. This is confirmed by the fact that, by mid-September, the risk premia of several euro area Member States reached or approached the levels observed in early May.

Table 1 provides a chronological summary of the proposals discussed above.

While the purpose of this article was to present, predominantly from an economic perspective, the proposals being forged, we should also stress the special role of legal considerations. There was a conscious effort to formulate all presented proposals in such a way, that their adoption would merely require the revision of secondary legislation without a need to revise the Treaty. Therefore, only the proposals not contradicting the provisions of the Treaty stand a real chance to become enacted regulations.

We should also touch upon equal treatment, a heavily discussed issue in the EU. On the one hand, in working out the proposals, several specific references have been made to this principle; e.g., when the Commission expressed its intention to set up a GDP-proportionate upper limit for the sanctions. On the other hand, as regards equal treatment, the logic applied by economics helps to avoid a situation where an apple has to be compared to a pear. On occasion of the previous reform of the SGP, Gábor Orbán and György Szapáry (2004) drew attention to the economic considerations concerning equal treatment: “In many documents and declarations reference is made to the ‘equal treatment’ of members when talking about the uniform application of the provisions of the SGP. Equal treatment in an economic sense would mean that one differentiates according to initial conditions and future liabilities...”. Indeed, in an economic sense, equal treatment would only prevail if a more indebted country would have to pursue a tighter fiscal policy than countries with a more favourable initial position and lower debt level.

CONCLUSIONS

In summing up the presented proposals, we should emphasise that the European Council will only make a final decision October; at this point, we only talk about drafts. Nevertheless, the main directions of the changes can already be foreseen with a reasonable certainty.

Decision-makers are determined to adopt economic policy coordination mechanisms far more efficient than the existing ones. Accordingly, they will rigorously assess both fiscal and real economic imbalances, and after the

imbalances have been identified, they will waste no time enforcing corrective mechanisms, including sanctions more severe than those in place. Rules governing crisis management will be certainly clearer; however, in order to minimise moral hazard, the common European rescue package will continue to come with a large price tag.

It is a warning sign, however, that despite firm policy intention, markets remain rather sceptical about the reform of the fiscal framework and the ability to guarantee the sustainability of fiscal policies, as indicated by the sovereign credit risk premia, which by September rose to the levels observed in May.

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